DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 00-0017
USE TAX
For Years 1996, 1997, AND 1998

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ISSUES

I. Use Tax—Activities exempted from use tax as "manufacturing"

Authority: IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-3-2; IC 6-2.5-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-26(d); 45 IAC 2.2-4-27; *Rotation Products Corp. v. Department of State Revenue,* 690 N.E.2d 795 (Ind. Tax Ct. 1998); *Ind. Dep't of State Revenue v. Interstate Warehousing, Inc.,* 783 N.E.2d 248 (Ind. 2003); 45 IAC 2.2-5-10(k); *Mid-America Energy Resources v. Indiana Dep't of State Revenue*, 681 N.E.2d 259 (Ind. Tax Ct. 1997); *Mechanics Laundry & Supply v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223 (Ind. Tax Ct. 1995); *Schulte Oil Co. v. State Tax Comm'n*, 882 P.2d 65 (Okla. 1994)

Taxpayer protests the classification of certain production activities as not entitled to exemption from Indiana use tax by way of the manufacturing exemption.

II. Penalty—Ten percent negligence penalty imposed

Authority: IC 6-8.1- 10-2.1(d)

Taxpayer requests waiver of the 10% negligence penalty imposed for failure to use ordinary business care.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation that is commercially domiciled in Indiana. The company is in the business of processing, assembling, packaging, distributing, refurbishing, and repairing wireless communication products, primarily cellular telephones and related accessories. The audit determined that several items purchased for use in the business were not purchased for purposes of manufacturing, but rather were purchased for non-exempt uses such as for "kitting" and repair services and office use. A timely protest was filed, with this Letter of Findings resulting.

I. Use Tax—Manufacturing exemption

DISCUSSION

Pursuant to IC 6-2.5-2-1, a sales tax, knows as state gross retail tax, is imposed on retail transactions made in Indiana. Retail transactions involve the transfer of tangible personal property. IC 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible property in Indiana if the property was acquired in a retail transaction. IC 6-2.5-3-2.

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production … manufacture … processing … or finishing of other tangible personal property. IC 6-2.5-5-3(b). Equipment purchased for direct use in direct production must have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). Property has an immediate effect on the article being produced if it is an essential part of an integrated process that produced tangible personal property. *Id*.

Office supplies, magazines, pager rental, etc.

Taxpayer contends that it is in the business of processing, assembling, packaging, and distributing wireless communication products and that these activities allow it to make use of an exemption from the sales/use tax for items purchased in furtherance of its business. IC 6-2.5-5-3. The audit revealed several items of which no manufacturing purpose could be demonstrated. These items included office supplies and other items that are not directly incorporated into the finished product. IC 6-2.5-3-2 covers such items as office supplies and equipment, software, printed material, etc. Taxpayer failed to remit use tax on several of these items. Also, 45 IAC 2.2-5-26(d) specifically requires payment of use tax for magazines and periodicals that are not newspapers. Finally, 45 IAC 2.2-4-27 requires the payment of use tax for the rental of tangible personal property. The renting of pagers for office personnel is covered under this provision.

For all of these items, the taxpayer is respectfully denied.

"Kitting"

The taxpayer engages in an activity referred to as "kitting," whereby an unusable product with the potential to become a cell phone is transformed into a workable phone by such things as the installation of SIMM (single inline memory module) chips and batteries. The phones are eventually sold to consumers, albeit not by the taxpayer.

Under the analysis in *Mid-America Energy Resources v. Indiana Dep't of State Revenue*, 681 N.E.2d 259 (Ind. Tax Ct. 1997), the type of production subject to the manufacturing exemption is any activity that creates a marketable good from an unmarketable good. This classification was upheld in *Rotation Products Corp. v. Department of State Revenue,* 690 N.E.2d 795 (Ind. Tax Ct. 1998). The case of *Ind. Dep't of State Revenue v. Interstate Warehousing, Inc.,* 783 N.E.2d 248 (Ind. 2003) takes the analysis a step further in requiring that these marketable goods actually be sold to consumers at some point down the stream of commerce. This sale distinguishes the taxpayer's activities from the activities of the taxpayer in *Interstate Warehousing,* where the taxpayer lost because the liquid ammonia it produced was merely a byproduct of the chilling process that it sold to customers. The liquid ammonia itself was never sold to an ultimate customer. The taxpayer's "kitting" process produces a marketable good that is sold by its customers.

However, the regulations don't let taxpayer off the hook so easily. In order to be covered by the exemption, a processed or refined end product, however, must be substantially different from the component materials used. 45 IAC 2.2-5-10(k).

Here, taxpayer has merely taken the components of a cell phone and put them together. A functioning cell phone is substantially different from a non-functioning cell phone only in the metaphysical sense. Just as when a functioning cell phone breaks and does not cease to be a cell phone, a nonfunctioning cell phone does not become a cell phone merely because it has the capability of placing and receiving calls. One may have a different value in the hands of the end-user, but the test is not one of valuation. The test is of substantial change, and taxpayer has failed to prove to the Department that the change in this instance is substantial.

Therefore, with regard to its "kitting" activities, taxpayer is respectfully denied.

Refurbishing and repair work

In its written brief to the department, the taxpayer admits that a "substantial (but not complete) portion of the proposed assessment" is eligible for exemption pursuant to IC 6-2.5-5-3. (parentheses added). In recognition of this substantial portion, the auditor in her summary performed on October 18, 1999, allowed taxpayer to claim that 70% of its refurbishing activities fell under the exemption. The taxpayer claimed, and the auditor agreed, that the remaining 30% of the taxpayer's activities fell under the guise of "repair" work that is not exempt from tax. Repairs are not afforded the exemption status conferred by 45 IAC 2.2-5-8, and *Rotation Products*, cited by the taxpayer in its protest, affirms that notion when a general repair activity creates no new products. See also *Mid-America Energy Resources*, 681 N.E.2d at 263 and *Mechanics Laundry & Supply v. Indiana Dep't of State Revenue*, 650 N.E.2d 1223, 1229-30 (Ind. Tax Ct. 1995).

The court determined that, in its remanufacture process, the taxpayer in *Rotation Products* created a new product when it took an unusable roller bearing and created a new product, i.e., a remanufactured roller bearing. Similar to that, taxpayer creates a new product when it transforms unusable and inactive cell phones into usable and active cell phones that are ultimately sold at retail. An estimated 70% of taxpayer's business is in the manufacture of refurbished phones.

The remaining 30% of taxpayer activities are repairs, by which the activity undertaken restores usability to a once usable phone. The Indiana Tax Court, in *Rotation Products*, cites to an Oklahoma case in distinguishing between a repairer and a manufacturer. "Ordinarily a repairer furnishes labor and material to the owner of an article for the purpose of restoring its normal condition. In this situation, the article remains the property of those for whom the service is performed. A manufacturer, on the other hand, purchases the article it ultimately transforms into a usable product and then puts it on the market." 690 N.E.2d at 801 footnote 12, citing *Schulte Oil Co. v. State Tax Comm'n*, 882 P.2d 65 (Okla. 1994). It is through this distinction that exemptions for repair work can be denied, as it becomes clear that a repair does not result in the creation of a new product. Rather, repair results in the restoration of an existing product.

The Indiana case of *Mechanics Laundry* also lends itself to the finding that repair work is not to be considered the production of tangible personal property for which the exemption applies. In that case, the taxpayer's services of laundering and repairing soiled and damaged textiles were held to be non-exempt activities. 650 N.E. 2d at 1229-30. "Mechanics Laundry does not produce goods or items of tangible personal property. … Its washing machines, driers, and other equipment are not used in an overall process directed to the production of textiles. They are used to perpetuate textiles that were produced by others." *Id*.

Therefore, with regard to the 30% of the taxpayer's process that falls into the category of repair, the taxpayer is respectfully denied.

FINDINGS

The taxpayer is respectfully denied.

II. Penalty—Negligence penalty

IC 6-8.1-10-2.1(d) provides:

> If a person subject to penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit the tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

With respect to the failure to remit use tax on office supplies, magazines, pager rental, etc., no reasonable cause is shown. With respect to the 30% of the taxpayer's refurbishing business that has been established to be repair work not subject to exemption from use tax, no reasonable cause is shown for the failure to remit use tax on items purchased in furtherance of these activities.

FINDINGS

The taxpayer is respectfully denied with regard to the 10% negligence penalty.

JM/MR 041305